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SUBJECT: NEW CAPITAL ACCOUNT LIBERALIZATION MEASURES SET THE STAGE FOR MORE OUTWARD INVESTMENT,INCLUDING THE QDII PROGRAM

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¶1. (SBU) Summary. China's financial authorities recently announced a series of capital account liberalization measures and provisions for introducing the long-awaited qualified domestic institutional investor (QDII) program. By allowing more forex to leave China and opening up the country's tightly restricted capital account, these regulatory adjustments may help address the pressures from China's burgeoning foreign exchange reserves, which reached US$ 875.1 billion as of March 31, 2006. Deputy Administrator of the State Administration of Foreign Exchange (SAFE) Wei Benhua suggested that the QDII program is likely to be relatively small at first. Other officials similarly indicated that the new policies would be implemented in a gradual way. While the new measures are clearly a welcome signal and may represent a major new policy shift, these statements indicate that the impact of the new measures will be limited in the near term. End Summary.

New Liberalization Measures

¶2. (U) Over several days in mid-April, the Chinese Government issued a series of new measures to ease capital controls and lay the groundwork for more outward investment. On April 13, A "Notice on Adjusting the Management Policies of Foreign Exchange in Current Accounts," issued by the People's Bank of China (PBOC) and the State Administration of Foreign Exchange (SAFE) on April 13 and due to take effect on May 1 simplifies approval procedures for forex accounts and payments. According to the notice, "the new rules have been launched in order to further satisfy the foreign exchange demand of domestic institutions and individuals and to facilitate trade development." Institutions will no longer need to obtain SAFE approval to establish, modify, or close their forex accounts; instead they may apply directly to banks.

¶3. (U) In addition, the amount of forex that institutions may retain will rise. Previously, the amount of forex a company could keep in its account was limited to between 50 percent or 80 percent of the forex income of the previous year. Starting May 1, a company may keep an amount equal

to the sum of 80 percent of its forex income and 50 percent of its forex expenditure from the previous year. For institutions with new accounts, the initial cap will be raised from US$ 200,000 to US$ 500,000.

¶4. (U) SAFE also indicated that Chinese citizens may purchase at least US$ 20,000 in foreign currency each year, and may obtain additional forex with a certificate that proves their need. To obtain foreign currency, domestic residents need to provide only their identity card.

¶5. (U) On April 18, the PBOC, the SAFE, and the China Banking Regulatory Commission (CBRC) jointly issued measures allowing commercial banks to invest their clients' funds offshore. Effective immediately, "This will widen domestic residents' investment channels in a positive and orderly way, and is a key measure toward helping to balance the international balance of payments," according to the statement released by the three agencies.

¶6. (U) PBOC official statistics indicate that deposits at China?s financial institutions totaled US$ 3.965 trillion at the end of March 2006, with personal deposits accounting for US$ 2 trillion of that amount. "Today the investment channel for domestic institutions and residents is relatively narrow, and it has been difficult to use the international financial markets to improve the asset portfolio, spread investment risk and improve the return on funds," the statement noted.

¶7. (U) Under the new rules, commercial banks must obtain regulatory approval to invest their clients' funds offshore, and will be assigned quotas, which may later be adjusted according to China's international balance of payments situation. Banks are required to hedge their

foreign exchange risk for their offshore investments, and must report their capital flows to SAFE periodically. The commercial banks must clearly inform their clients of the investment risks and the performance of their investments.

¶8. (U) The rules also require the commercial banks to have a custodian bank that will be responsible for all the assets invested offshore. The domestic custodian bank must also assign another qualified foreign financial institution to handle offshore settlements and hold the securities in a separate account.

¶9. (U) Wu Dingfu, Chairman of the China Insurance Regulatory Commission (CIRC), announced last week that the State Council has approved plans to allow local insurers to purchase foreign currencies with their own yuan-denominated funds to invest overseas. "A pilot program will be launched in the first half of this year," Wu confirmed, adding "CIRC will chose one or two insurance firms to start the pilot program." In September 2005, CIRC authorized domestic insurers to invest a maximum 10 percent of their foreign exchange capital in overseas stocks of Chinese companies.

Implementation is the Key

¶10. (SBU) Despite these encouraging policy announcements, Econoff contacts agreed that the key lies with implementation. A senior executive at an economic consulting firm pointed out, "Chinese individual investors are unfamiliar with overseas bond markets," and added that even Chinese banks themselves are not good at analyzing higher yielding but more risky overseas investment products. He concluded it will take about two or three years before the market matures. Ha Jiming, Chief Economist with CICC, agreed that implementation would be slow. He noted that some of China's insurance companies have already been allowed to participate in China IPOs in Hong Kong, but he expects investment in stocks and bonds will be allowed in

other overseas markets as well.

SAFE's Wei Predicts QDII Before Year End

¶11. (SBU) Wei Benhua, Deputy Administrator at SAFE, advised Econ Mincouns that these steps do indeed signal a new effort to expand outward investment options, especially for the Qualified Domestic Institutional Investor (QDII) program. He indicated that banks and insurance companies will be confined to fixed income products in overseas markets, but securities firms and investment funds will be able to invest in overseas stock markets as well. He pointed out that any institution, domestic or foreign, that is registered in China could qualify as a QDII.

¶12. (SBU) As for implementation of the new outward investment measures, Wei confirmed that implementing regulations must be issued before they can begin. Wei indicated that the QDII program will be phased in over time, with an approach that will likely seek a balance between the QDII and QFII (Qualified Foreign Institutional Investor) programs. This would imply the QDII program will initially match the size of the QFII program, which currently has a quota of US$ 10 billion, US$ 6 billion of which has been issued to 39 QFIIs. Wei said he hopes the QDII can be launched before the end of the year.

Gradual Process

¶13. (SBU) In a similarly cautious vein, the China Financial News cited SAFE Assistant Administrator Li Dongrong as saying "We must be clear-headed in the process of steadily pushing forward capital account liberalization, refrain from being rigid and conservative, but prevent any blind and rash moves." Qi Bin, Director General of the Research Department at the China Securities Regulatory Commission, informed a group of U.S. Federal Reserve officials during a mid-April meeting not to anticipate a flood of investment overseas in the near term. Instead, "gradualism" remains the focus in implementing the

regulations, according to Qi.

¶14. (U) Currently, no domestic institution has yet been granted a QDII license, although the China Securities Journal reported recently the National Council for Social Security Fund would likely become the first organization to receive a license during the second quarter of this year. Indeed, in late March, Hong Kong Exchanges & Clearing Ltd. announced it admitted China's Social Security Fund to its settlement system, which appeared to pave the way for Chinese institutions to invest in overseas securities. The creation of the account removes a technical hurdle for the council to make overseas investments through the QDII program.

Comment

¶15. (SBU) This series of new measures may represent the most significant policy shift so far in the Government's efforts to liberalize its tight currency control. This could open the way for Chinese institutions and individuals to obtain higher returns and diversify their investment portfolios through investing overseas. There may also be new opportunities for U.S. financial firms to provide investment management and related financial services. However, in keeping with China's gradualist policy approach, these new steps are likely to be implemented slowly and in a limited way. China's forex reserves are growing at a slower pace, but still increased by US$ 20 billion in the first quarter. If, as suggested, the QDII program will only have a quota of US$ 10 billion, the Government will need to accelerate the implementation

process.

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